

No. 76-424

Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1976

SAIA ELECTRIC, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE FIFTH CIRCUIT**

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

**ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.**

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The sole question presented in this federal income tax case is whether part of the purported compensation paid by petitioner to its chief officer and controlling shareholder was unreasonable and therefore not deductible under Section 162(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.).

The pertinent facts are as follows: Petitioner is in the electrical contracting business. Its president and controlling shareholder was Frank J. Saia, who owned 98.7 percent of petitioner's stock (Pet. App. B 15). Pursuant to a contingent compensation agreement, petitioner annually paid Saia 40 percent of its net earnings (computed before deducting income taxes or Saia's salary) (Pet. App. B 17). For the taxable year ended February 28, 1969, petitioner paid Saia \$301,292.95 under the compensation agreement and claimed a deduction for that amount on its corporate

tax return. On audit, the Commissioner of Internal Revenue determined that Saia's compensation was unreasonable to the extent it exceeded \$100,000 and reduced petitioner's claimed deduction to that amount (Pet. App. B 22).

In appraising the reasonableness of petitioner's compensation to Saia, the Tax Court considered the nature of Saia's work, the size and complexity of petitioner's business, the prevailing rates of compensation for comparable positions in other firms, petitioner's salary policy with regard to its nonstockholder employees, and petitioner's dividend history. Based upon an analysis of these factors, the court concluded that \$175,000 was the maximum amount allowable as reasonable compensation that could be deducted under Section 162 of the Code (Pet. App. B 27). The court of appeals affirmed *per curiam* (Pet. App. A 13).

There is no basis for further review of the factual question of the reasonableness of petitioner's compensation to its chief officer who was also its controlling shareholder.

Petitioner challenges (Pet. 6) the Tax Court's statement that salaries paid by corporations to their controlling shareholders should be carefully scrutinized in order to insure that such salaries are not in fact disguised dividends. But that proposition is in accord with numerous appellate decisions as well as the applicable Treasury Regulations. See, e.g., *Charles Schneider & Co., Inc. v. Commissioner*, 500 F. 2d 148 (C.A. 8); *Miller Box, Inc. v. United States*, 488 F. 2d 695 (C.A. 5), certiorari denied, 417 U.S. 945; *Jones Brothers Bakery, Inc. v. United States*, 411 F. 2d 1282, 1293 (Ct. Cl.); Treasury Regulations on Income Tax (1954 Code), Section 1.162-7 (26 C.F.R.). Moreover, the fact that a corporation and its shareholders are separate taxable entities does not require, as petitioner suggests (Pet. 6), that the Commissioner and

the courts accept non-arm's length compensation agreements between closely-held corporations and their shareholder-employees. On the contrary, such compensation agreements are to be disregarded where the payments in question are not solely for services rendered. *Botany Mills v. United States*, 278 U.S. 282, 292.

Finally, petitioner contends (Pet. 7-10) that the decision below discriminates against closely-held corporations because the compensation arrangements of publicly-held corporations are usually not subject to the same scrutiny as those of small businesses. But the compensation paid by publicly-held corporations is subject to the scrutiny of the shareholders, who can act to prevent unreasonable amounts. Since there is unlikely to be comparable scrutiny in closely-held corporations, those firms are more likely to distribute dividends under the guise of deductible salary payments. The special scrutiny given the compensation arrangements of closely-held corporations is thus appropriate.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

NOVEMBER 1976.